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Expert Analysis

Enforcing Preliminary Agreements Under New York Federal Law

When will an "agreement to agree" be enforceable, and when can you require another party to negotiate with you? New York's federal courts provide a legal framework that answers both of these questions.

In today's faced-paced world, when complex commercial transactions are frequently negotiated under time constraints, the enforceability of such agreements is especially relevant.

Ordinarily, parties that agree to a deal while expecting to negotiate further and execute later writings merely agree to non-binding proposals or statements of intent. Neither party is obligated to perform the ultimate contractual objectives or even to continue negotiating.

Type I and Type II Preliminary Agreements

However, in *Teachers Insurance & Annuity Assoc. v. Tribune Co.*, *Teachers Insurance & Annuity Assoc. v. Tribune Co.*, 670 F. Supp. 491 (S.D.N.Y. 1987), then District Court Judge Pierre Leval recognized two types of binding

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preliminary agreements. The Second Circuit adopted Judge Leval's analysis and categorized these two agreements as "Type I" and "Type II" preliminary agreements. See *Vacold LLC v. Cerami*, 545 F.3d 114, 124 n. 2 (2d Cir. 2008).

Parties enter into a Type I agreement when they reach complete agreement on all issues perceived to require negotiation (including to be bound), though they contemplate executing a later, more formal writing. This agreement is preliminary only in form. The subsequent writing is merely desirable, not necessary, and is effectively irrelevant.

A Type I agreement binds the parties to their contractual obligations, as a contract has already been reached despite the desire for a more formal document. Thus, even if the parties never execute the subsequent writing, a Type I agreement is fully enforceable.

Parties enter into a Type II agreement when they agree upon the "major" terms of their agreement, while acknowledging open terms which they commit to negotiating. It does not guarantee the execution of the ultimate contract. Good faith differences in the negotiation of the open terms may prevent it, or the parties may mutually abandon negotiations if circumstances change.

Thus, a Type II agreement does not bind the parties to their contractual promises. It obligates the parties to negotiate open terms in good faith and to refrain from actions that contravene the negotiations, such as by insisting upon terms that conflict with the initial agreement. If the parties fail to reach a final agreement after good faith efforts, there is no further obligation upon either.

A Type I agreement binds the parties to their contractual obligations, as a contract has already been reached despite the desire for a more formal document.

While the New York Court of Appeals has termed the Second Circuit's Type I/Type II classifications as "rigid" and not "useful," it nonetheless "do[es] not disagree with the reasoning." *IDT Corp. v. Tyco Grp.*, 13 N.Y.3d 209, 215 n. 2, 890 N.Y.S.2d 401 (2009).

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New York's federal courts continue to employ the Second Circuit's Type I/Type II framework and have stated they will continue to do so until a pronouncement by the Second Circuit or Court of Appeals not to.

Policy Considerations

Because contract law aims to gratify, not defeat expectations, courts preserve and enforce agreements that were intended to be binding, in the manner they were intended to be. Enforcing these agreements is beneficial for the marketplace.

A Type I agreement is a fully binding contract. The fact that the parties contemplate a more formal writing should not prevent their prior agreement from being enforced.

A Type II agreement assures that a party's investments in time, money and effort will not be wiped out by its counterparty's bad faith change of position.

Second Circuit's Tests

The Second Circuit test for a Type I agreement considers four factors: (1) whether the agreement contains a reservation not to be bound in the absence of a later writing; (2) whether there has been partial performance of the agreement; (3) whether all of the agreement's terms have been agreed upon; and (4) whether the agreement at issue is the kind that is usually committed to writing. The test for a Type II agreement essentially considers the same four factors and a fifth: the context of the negotiations.

Party Intent

Party intent is the most important factor. A court will discern objective indications of intent from the parties' words and conduct.

The Agreement's Language. The agreement's own language is most critical. Merger clauses, terms calling for immediate performance, and provisions that the parties are bound even absent a future instrument evidence a Type I agreement. The words "subject to" will not necessarily negate an intent to be bound. If the agreement is premised on conditions precedent, it is unenforceable unless and until those conditions have been fulfilled.

A Type II agreement must convey that the parties agreed to the major terms and will negotiate remaining open terms. If the parties merely express a generalized intent to negotiate, leaving open terms of too-fundamental importance or failing to commit to negotiations, a court will presume that the parties intended to negotiate while remaining free from binding obligations.

Partial Performance: Partial performance under the agreement, accepted by the other party, evidences a binding agreement. A court may discount even substantial partial performance, however, given other evidence. Mere preparatory acts in anticipation of the agreement are also insufficient.

Open Terms: A court will employ a flexible analysis to determine whether the parties agreed upon the necessary aspects of their agreement, assessing the significance of open terms and the subject matter, complexity, and purpose of the agreement.

Type of Contract: In determining whether the agreement is the kind usually committed to writing, a court will consider the size and complexity of the transaction, the subject matter, and the amount of money involved. These questions of fact are informed in large part by industry custom and practice.

Context of Negotiations: A court may consider the length of the negotiations as well as events and party expenditures during negotiations.

Remedies and Enforcement

A party to a Type I agreement may enforce it, as any contract, through an action for damages or specific performance.

A party to a Type II agreement may enforce it by seeking equitable relief concerning the negotiations, i.e., an injunction or specific performance.

However, a party to a Type II agreement cannot recover expectation or "benefit of the bargain" damages, because the agreement reached is not to perform the contractual promises, but rather, to negotiate open terms. Nonetheless, certain courts have acknowledged a possible right to recover reliance damages or out-of-pocket costs incurred during negotiations.